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Research and Development Acquired in a Business Combination

BUSINESS ADVISORS, BUSINESS VALUATION
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Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 805 requires that an acquirer of a business record, separately from goodwill, the identifiable assets (tangible and intangible) and liabilities assumed of the acquired entity at their acquisition date fair values. In-process research and development ("IPR&D") is one intangible asset that meets the FASB's definition of an intangible asset separately identifiable from goodwill. This article provides some examples of IPR&D assets and a brief discussion of some common valuation methods used to determine the fair value of IPR&D acquired in business combinations.

As outlined in ASC 730, some examples of R&D activities include:

- Laboratory research aimed at discovery of new knowledge;
- Formulation and design of possible product or process alternatives; and
- Design of tools, jigs, molds and dies involving new technology.

The Multi-Period Excess Earnings Method ("MPEEM"), a form of the Income Approach to valuation, is the most common method used to value IPR&D assets. The MPEEM first involves forecasting the cash flows attributable to the IPR&D assets. Next, contributory asset charges are removed from the cash flows to arrive at excess earnings attributable solely to the IPR&D. Contributory asset charges represent the cost of using assets (e.g., working capital, fixed assets and other intangible assets) needed to support the IPR&D cash flows. For example, a contributory charge for lab equipment would be necessary to support laboratory research IPR&D. Finally, the excess earnings are discounted to their present value to determine the fair value of the IPR&D. The value of the tax benefit from amortizing the asset for tax purposes should also be considered.

The Cost Approach establishes value based on the current costs needed to reproduce or replace the IPR&D. The purpose of IPR&D is normally to develop commercial products that are expected to generate future profits. When reliable earnings forecasts are available, the Income Approach (specifically, the MPEEM) normally provides a more appropriate indication of value as opposed to an analysis of the historical costs to produce the asset. However, the Cost Approach may be appropriate in certain instances. For example, if the products that are subject to the IPR&D are still undergoing significant testing, and it is far too early to forecast potential earnings generated by the products (if any), the Cost Approach may be appropriate.

The Market Approach to valuation estimates the fair value of IPR&D using sale prices of similar intangible property. However, IPR&D assets typically are not transferred individually without the rest of the business, and when they are transferred individually, they are rarely comparable to the subject IPR&D because it is often very unique. Therefore, the Market Approach is seldom used to value IPR&D.

Schneider Downs has significant experience in determining the fair value of intangible assets acquired through business combinations in order to comply with ASC 805. For more information about Schneider Downs' business valuation and other business advisory services, please contact Joel Rosenthal at 412.697.5387 or jrosenthal@schneiderdowns.com or Tom Claassen at 412.697.5330 or tclaassen@schneiderdowns.com.

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